performed in this connection is for products and simple services with readily available performance specifications and prices. The proposed effort, by contrast, would typically involve the evaluation of services with a much broader spectrum and complexity of requirements. Directly comparable feature/function/price comparisons are seldom readily available, if at all. This entails significant expenditures and resources, and where vendors suspect there is not an intent to outsource, accurate bids are extremely difficult to obtain. Often vendors will just elect not to bid. Sometimes vendors may even request fees to perform this service. Also, it must be borne in mind that services performed by an outside resource increase other internal costs, e.g., insurance and coordination costs. Further, the proposal would increase manifold the effort that is currently performed at Telesector Resources Group.

The cost of this additional burden would more than offset any perceived benefit the Commission's proposal would have for the ratepayers. Even after the LECs have determined, in good faith, what the fair market value is for a specific service, the Commission's staff or auditors could disagree subsequently, requiring the LECs to further expend resources to defend their decisions. All this would defeat the LECs' and the Commission's common goal of achieving cost efficiency without any improvement in the accuracy of the determination of the booked amount.

NYNEX is sensitive, however, to our regulators' concern regarding pricing of affiliate transactions. As mentioned previously, NYNEX has therefore adopted an Affiliate

Transactions Policy in 1991 that virtually eliminates affiliate transactions between the Telecommunications Affiliates and Non-Telephone Affiliates. This Policy in effect accomplishes the Commission's goals in the NPRM without incurring the additional costs associated with the investigation of fair market value for services. As indicated infra, the Commission should permit the carriers and the affiliates established for the primary purpose of supporting them to be treated as a unit, using fully allocated cost (absent a tariff or prevailing company price) as the pricing methodology among them.

Compliance with the Policy is ensured by a staff at NYNEX that reviews annually the fully allocated cost calculations of all Non-Telephone Affiliates. If the fully allocated cost of the service is below the price charged external customers, then the affiliate will charge fully allocated cost. If the price charged external customers is below fully allocated cost, then the price charged external customers will be used for charging the Telecommunications Affiliates even though the Non-Telephone Affiliate may not have a substantial external market. During the fully allocated cost reviews, if the charges to affiliates are above fully allocated cost, then adjustments will be made to refund the difference. If the charges are below fully allocated cost, no adjustments will be made.

Finally, it should be noted that the Commission's concern underlying the service rules, i.e. to guard against carrier imprudence, has been a concern historically at the heart of regulatory rate proceedings. The Commission need not and should not engraft traditional ratemaking inquiries onto increasingly complicated affiliate transaction accounting rules. Instead, subject to existing rules and proceedings, the FCC (and state commissions) can properly continue to specifically evaluate under the "just and reasonable" standard any affiliate transaction costs.

B. Prevailing Company Prices

1. FCC Proposal

The Commission notes that under its current rules:

> A non-tariffed asset or service is deemed to have a prevailing company price whenever the affiliate that provides the asset or service also provides substantial quantities of it to non-affiliates. When such a price exists, the rules require the carrier to record the affiliate transaction at that price.[40]

Citing concerns that affiliate transactions may be dissimilar to non-affiliate transactions, the Commission proposes to "curtail sharply" its reliance on prevailing company prices:

> we tentatively conclude that we should discontinue prevailing company pricing as a valuation method for transactions between carriers and nonregulated affiliates having a primary purpose to serve the carrier and other affiliates....
>
> [W]e propose to continue to allow prevailing company pricing only for affiliate transactions in which the nonregulated affiliate sells at least

40 NPRM para 15.

> 75 percent of its output to non-affiliates.[41]

Finally, the Commission "invite[s] comment on the role the prices the providing affiliate charges non-affiliates should play in the determination of fair market value."[42]

2. NYNEX Position

Under the Commission's current rules, "substantial" sales to nonaffiliates establishes a prevailing company price. This rule is based on the sound theory that if third parties are willing to pay such price in arm's length transactions with a willing seller, then the price is a good indicator of value and is reasonable for recognition in affiliate transactions. Indeed, the Commission acknowledges that:

> the fair market value of assets and services carriers provide nonregulated affiliates is unlikely to fall below the prices carriers charge non-affiliates. We also believe that the fair market value of assets and services nonregulated affiliates provide carriers is unlikely to exceed the prices nonregulated affiliates charge non-affiliates.[43]

---

41 NPRM paras. 19, 22.

42 NPRM para. 92.

43 NPRM para. 92. See also definition of "fair market price" and "fair market value" in Black's Law Dictionary, supra: "The amount at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts ... in the open market.... Usually the fair market price will be the price at which bona fide sales have been consummated for assets of like type, quality, and quantity in a particular market at the time of acquisition."

That is, the FCC virtually concedes that prevailing company price accurately reflects fair market value. Yet, the FCC would curtail sharply its reliance on prevailing company pricing and, under its proposal, would rely on the vague standard of fair market value. This is not a logical, or consistent, approach.

The Commission suggests that because affiliates are under common control, they may be "captive customers" of each other, and conduct business differently from non-affiliate transactions.[44] The Commission's analysis here is misplaced and unrelated to its purported purpose of finding a reasonably reliable measure of fair market value. The fact that the costs incurred in conducting business with affiliates may not be the same as costs incurred in conducting business with external customers has no relevance in determining fair market value.

The use of prevailing company price when a substantial external market exists should be continued, e.g. in NYNEX the use of detariffed or non-tariffed cellular rates. The Commission is attempting to define "substantial external market" as selling 75% or more externally. The adoption of a clear definition will clarify the rule and also establish consistency in application by the LECs. However, in view of the fast-paced changes and uncertainty of the industry, 75% is too high, especially considering that new businesses arising from customer demand and new technology require years to establish a customer base. The Commission should not adopt

---

44 NPRM para. 18.

inflexible rules in this respect. There is a valid basis for assuming that a percent of sales much less than 75% constitutes an accurate measure of "fair market value."

In any event, based on the current record, there is no basis to assume that if any arm's length third party buyer is willing to complete the transaction at a certain price, that price is not a "fair market value." Thus, that is a reasonable price at which to book the same transaction with an affiliate. The NPRM is internally inconsistent in recognizing what will establish a true fair market value. On the one hand, for purposes of determining the value of services, the NPRM contemplates merely a single bid as constituting an accurate determination of fair market value. On the other hand, the NPRM assumes that it is necessary to look at 75% of actual sales to determine an accurate fair market value for goods and services provided both to the external market and to affiliates.

Therefore, the Commission's current rule, as well as its proposed modification, are more stringent than necessary. The Commission's rule in this regard should only require that the third party transactions used to establish fair market value be truly arm's length and that the parallel affiliate transaction be equivalent to that which was conducted with the third party. In order to be reflective of this reality, the percentage adopted by the Commission should be significantly lower than 75%.

C. Chain Transactions

1. FCC Proposal

The Commission indicates that "chain transactions" are "affiliate transactions involv[ing] resources that the provider obtained from another member of the affiliate group."[45] For chain transactions, the Commission proposes:

> to require carriers to calculate the costs of resources obtained from other affiliates in accordance with the valuation methods proposed in this Notice. Under this approach, carriers would continue to trace resources used in affiliate transactions to determine whether the resources had been transferred between or among affiliates prior to the transactions.... Alternatively, we could require that all resources used in affiliate transactions be valued at their original cost to the affiliate group regardless of whether they had previously been transferred between or among affiliates.[46]

2. NYNEX Position

The accounting systems currently in-place in NYNEX do not separately identify costs incurred in providing affiliate transactions from costs incurred in providing external sales. Obviously a change in the accounting system to do this would be very costly. Individual affiliate's total costs are used in determining fully allocated costs which are then allocated

---

45 NPRM para. 48.

46 NPRM paras. 49-50. See also NPRM paras. 11-12 n. 16 (regarding "affiliate group" costs) and para. 39 (regarding concerns with "subsidy" arrangements in chain transactions possibly leading to increased regulated costs).

between affiliate sales and external sales. To determine fully allocated costs using the costs of the affiliate group as a whole would introduce unnecessary complications and may distort results.

Furthermore, an affiliate may obtain goods and services from another affiliate to support its internal operations, the cost of which becomes overhead and included as part of the cost of the second affiliate in providing goods or services to external customers and affiliates alike. (Although note 50 in the NPRM seems to be excluding this type of transaction from the tracing rule by adding the qualifier "without adding value to it," it is not clear because the footnote goes on to discuss "costs incurred in handling the item" which can be the value added.)

Therefore the tracing proposed by the Commission is impossible and, contrary to the Commission's belief, it is unnecessarily burdensome to the carriers and the Commission. The goal of protecting ratepayers should be achieved in alternative ways. The Commission's objective apparently is to prevent certain non-cost based "mark-ups" from being passed through to the telephone ratepayer. In this light, it would be sufficient to require that fully allocated cost be used (absent an applicable tariff rate or prevailing company price). The current practice, of the Materials Management Department in Telesector Resources Group, of charging affiliates the vendor price for the goods purchased without any mark-up, and separately charging fully allocated costs incurred in providing services should satisfy the Commission's goal in this respect.

As referenced earlier, the Commission expresses the following concern:

> [W]hen a carrier sells a product to a nonregulated affiliate under a "subsidy" arrangement,...[t]he nonregulated affiliate ... could use the product to supply the carrier with a second product. If the carrier were to record this second product at the nonregulated affiliate's "cost," the "subsidy" arrangement would result in an increase in regulated costs.... We ask the commenters to address how we can avoid such increases while allowing valuation methods that reduce interstate costs.[47]

The same situation happens under the Commission's current asset transfer rules requiring carriers to record asset transfers to their nonregulated affiliates at the higher of net book cost or fair market value. An example will help in explaining the situation. Earlier this year, NYNEX decided to consolidate its training functions for the NYNEX Telephone Companies to achieve cost efficiency. In conjunction with that consolidation, it was contemplated that a training center owned by New England Telephone would be transferred to the subsidiary performing the training functions. The training center was not transferred because the fair market value was higher than the net book cost, and NYNEX was concerned that the training costs from the nonregulated subsidiary charged to the NYNEX Telephone Companies would be artificially inflated by transferring the training center at fair market value. If the Commission's

---

47 NPRM para. 39.

proposal for the pricing of services among affiliates were adopted, this problem would be magnified many times.

Therefore, NYNEX proposes that the LECs and the affiliates established for the primary purpose of supporting them[48] should be allowed to be treated as a unit, using fully allocated cost (absent a tariff or prevailing company price) as the pricing methodology among them.

D. Fully Allocated Cost

1. Rate Base

a. FCC Proposal

The Commission describes a "generic rate base methodology ... to use in determining the fully distributed costs of services nonregulated affiliates provide carriers."[49] The Commission proposes:

> to require all carriers subject to the affiliate transactions rules to comply with the [generic rate base] methodology proposed above, in determining the costs of those affiliate transactions that our proposed valuation methods would require them to record at cost. We invite comment on this proposal and on whether we should modify the existing methodology in other respects.[50]

b. NYNEX Position

---

48 I.e., the Telecommunications Affiliates, NYNEX Corporate and NYNEX Government Affairs.

49 NPRM para. 58.

50 NPRM para. 65; see also NPRM paras. 60-64.

NYNEX concurs with use of the generic rate base methodology with the modifications described below.

First, it must be clarified that the NYNEX Telephone Companies do not use the generic rate base methodology for determining the cost of providing non-tariffed services to nonregulated affiliates. The same rate base methodology as that set forth in FCC Part 65 rules is used.

Second, the generic rate base methodology was developed to provide guidelines to nonregulated affiliates having different and distinct accounting requirements from the carriers. The methodology eliminates the confusion of applying a Part 65 methodology that is not suitable for nonregulated affiliates' operations, and provides certainty and ease of application for the nonregulated affiliates. If the Commission thinks that certain accounts need to be excluded from the determination of the rate base by the nonregulated affiliates, the Commission should identify the specific exclusions -- and not simply indicate that the Part 65 treatment should be followed -- in order that the generic rate base goal of providing certainty and clarity can be maintained.

Third, NYNEX recommends that the temporary cash investment account be included in the generic rate base formula. Temporary cash investments represent investments made by NYNEX in short-term instruments, ranging from overnight to 30 days, with funds from operations. These are funds required for meeting NYNEX's cash obligations. NYNEX exercises its prudent business judgment by ensuring that these funds are invested in secure and liquid (marketable) money market instruments which will provide the highest yields. The generic rate base formula specifically excludes this account from the rate base calculation, in effect penalizing NYNEX management for prudent business actions. Had the short-term investment not been made, the amount would be in the cash account, which is includible in the rate base. Therefore, NYNEX recommends that the temporary cash investment account be included in the generic rate base calculation. The interest earned on these investments should be used to offset the return requirement.

2. <u>Rate Of Return On Investment</u>

a. <u>FCC Proposal</u>

The Commission's affiliate transaction rules permit a return on investment to be included as a component of fully allocated cost.[51] The Commission makes the following proposals in this area:

> Since those LECs' rates are based on the 11.25 percent rate of return ... we propose to require ... that rate of return in calculating affiliate transactions costs.
>
> [O]ur regulation of LECs has ... resulted in ... regulatory approaches ranging from traditional, rate of return regulation to price caps. We invite the commenters to address whether we should vary the rate of return used in calculating affiliate transactions costs, depending on how we regulate the individual LEC.
>
> [W]e invite comment on whether we should require price cap LECs to compute their affiliate transactions

51 See NPRM para. 66.

> costs using rates of return from within these ranges ... and, if so, what rates of return we should require. We request that the commenters address, in particular, whether we should pick percentages that reflect the rate of return on interstate access service each price cap LEC actually achieves after sharing.
>
> [W]e invite comment on whether we should require or permit any LEC to determine the return component of affiliate transactions costs using a composite of the prescribed, interstate rate of return and the intrastate rates of return prescribed or authorized for the LEC. We also invite comment on how this composite should be calculated and on whether the benefits of this approach would exceed the additional burden of such calculations. We ask the commenters to discuss whether this approach would improperly delegate to state regulators our authority over federal accounting matters.[52]

b. NYNEX Position

Consistent with the goal of providing certainty and clarity, NYNEX proposes that the prescribed interstate rate of return, e.g., currently 11.25 percent, be used by all LECs, whether traditional or price-cap regulated, in determining the return component of fully allocated costs. Of course, NYNEX would not object to the Commission permitting a higher rate of return to be used for this purpose. However, the use of a higher rate of return must be consistently applied for transactions going into and out of the LECs, and must not be contingent upon undeterminable criteria at the time of the transaction, e.g. the LECs achieving certain results for the

---

52 NPRM paras. 67-71.

whole year such as the actually achieved rate of return. Such contingent treatment would undermine the goal of providing certainty. (The Commission could allow a rate of return based on the LEC's previous year's actually achieved rate of return, but not below the prescribed 11.25 percent.)

With respect to the treatment of intrastate rates of return, NYNEX proposes that the FCC permit a carrier to use a rate of return different from the FCC prescribed rate so that the carrier can meet its obligations to both federal and state regulators and reduce its record-keeping burden.

3. Fully Allocated Cost Estimation And True-Up Process

a. FCC Proposal

> [W]e believe that carriers should maintain procedures for estimating affiliate transactions costs, monitoring the estimates' accuracy, and truing-up if they prove inaccurate. We propose to require carriers to use the methods described below in performing these functions. We invite comment on these methods.[53]

b. NYNEX Position

The Commission's proposal in effect requires that affiliate transaction costs be estimated based on company budgets, updated every quarter, and trued-up at the end of the year. The Commission's proposal is a workable method. However, NYNEX recommends that the Commission's proposal be adopted as one of several alternatives, and not as the only method.

---

53 NPRM para. 77; see also NPRM paras. 78-81.

NYNEX has regularly reviewed its cost allocation procedures in order to ensure that its costs are allocated as accurately and as promptly as reasonable. Each month prior to the closing of the books, an expense report is generated from which accruals of cost allocations are made. Any difference in the expenses after the books are closed is trued-up in the subsequent month. NYNEX thinks that this procedure produces results at least as accurate as the one proposed by the Commission, and thus NYNEX should not be required to incur the costs necessary to change its practice when there is no discernible benefit to the rate payer. Under this method, the true-up of the December month will be recorded in January of the subsequent year. However, the December true-up should not be a significant amount. The Commission should clarify in its rules that the true-up amount for the preceding year should be excluded from the external auditors' attestation audit of the LECs' compliance with the Commission's rules in the current year.

E. Cost Allocation Manual Requirements

1. More Detailed Cost Apportionments

a. FCC Proposal

> We invite comment on how precise we should require this [affiliate transaction cost] apportionment process to be.... [O]ur existing rules require a further apportionment of the nonregulated costs between affiliate transactions and third party transactions. There might have to be additional apportionments if some of the affiliate transactions were to be recorded at fully distributed costs and others at prevailing company prices or

> estimated fair market value. We ask that the commenters address whether each of these steps needs to be performed with equal exactitude....
>
> The rules also contemplate that the costs apportioned to affiliate transactions will be further apportioned between those affiliate transactions that are to be recorded at prevailing company prices and those that are to be recorded at cost.... We invite comment on whether these additional apportionments should be retained.[54]

b. NYNEX Position

These additional requirements to apportion affiliate transaction costs further into fully distributed cost, prevailing company prices, and estimated fair market value would impose burdensome requirements without any benefit to ratepayers. As the Commission recognizes in these paragraphs, costs associated with affiliate transactions are derived from apportioning the total costs incurred. Any further apportionment will necessarily be based on some apportionment factors. As long as the fully allocated costs associated with affiliate transactions can be determined, NYNEX does not see any benefit from further apportioning the costs so determined into the various pricing categories. Thus, this creates an unnecessary burden without a concomitant benefit and should be rejected.

---

54 NPRM paras. 55-56.

2. Cost Manual And Audit Trail

a. FCC Proposal

> In lieu of specifying procedures for carriers to use in estimating fair market value, we propose to require that cost manuals describe the carriers' proposed procedures.... We propose to amend this rule to make clear that the scope of the independent audit must encompass compliance with any requirements we adopt in this proceeding. We invite comment on this proposal....
>
> We propose to incorporate an audit trail requirement into our rules.[55]

b. NYNEX Position

NYNEX opposes any setting of specific requirements in the area of audit trail documentation. Each company must, of course, comply with all FCC affiliate transactions rules and orders, and follow its approved Cost Allocation Manual. A company's system of internal controls would, by definition, incorporate audit trails sufficient to document support for all transactions. Further, auditors are subject to Generally Accepted Auditing Standards. Requirements governing the degree of audit trail documentation appropriately should continue to be defined by management.

---

55 NPRM paras. 97-99.

F. Relatively Minor Clarifications

1. Tariff Rates

a. FCC Proposal

> [W]e propose to retain our requirement that affiliate transactions provided pursuant to tariff be recorded at tariff rates.
>
> We also propose to treat affiliate transactions as being provided pursuant to tariff only if the tariff is generally available, on file with a federal or state agency, and in effect.[56]

b. NYNEX Position

NYNEX concurs with the Commission's proposal and we only request that the definition be clarified or expanded to cover local government regulatory agencies below the state level. For example, Empire City Subway, a subsidiary of New York Telephone, provides certain conduit rentals to New York Telephone and nonaffiliates at prices on file with and approved by New York City. Under the FCC's affiliate transaction rules, such prices should be treated no differently than tariff rates on file with the NY PSC, for example.

2. Reserves

a. FCC Proposal

> Our proposed definition of cost would also require that the transferred

---

56 NPRM paras. 13-14.

> resource's cost reflect ... deferred taxes, unamortized investment tax credits, and depletion allowances, as applicable. We invite comment on whether these reserves should be included in carriers' cost calculations....[57]

b. NYNEX Position

With respect to the transfer of assets, the treatment of the associated deferred tax reserve is determined by tax law based on how the asset transfer is accomplished. If the liability for previously deferred taxes rests with the transferor, then the deferred tax reserve should not be transferred with the asset. If the liability for the previously deferred taxes rests with the transferee, then the deferred tax reserve should be transferred with the asset. Therefore, it is important that the Commission make clear that the reserves associated with the asset should be included only "as applicable."

IV. CONCLUSION

Any changes by the FCC to its affiliate transaction rules should fairly take account of the current telecommunications environment. That environment is characterized by price cap/incentive regulation, burgeoning competition, already extremely intense regulatory scrutiny of affiliate transactions, and (for NYNEX) an Affiliate Transactions Restructuring Policy that has limited affiliate

---

57 NPRM para. 53.

transactions and taken extra steps to safeguard the telephone ratepayer's interests. All these factors have heightened carriers' incentives to be efficient and cut costs, and have sharply limited any carrier incentive or ability to shift affiliate transaction costs to the detriment of the ratepayer. In light of these factors, less rather than more affiliate transaction rules would be warranted. Accordingly, and for all the reasons discussed in these Comments, the FCC should refrain from imposing additional, costly and burdensome affiliate transaction rules which would not serve the public interest. The Commission's proposal to require estimated fair market value for a myriad of affiliate services is particularly onerous,inappropriate and impractical, and should be discarded. In all events, the Commission should defer action on this NPRM until after it completes its imminent review of the experience under LEC price cap regulation.

Respectfully submitted,

New York Telephone Company
and
New England Telephone and
Telegraph Company

By: Mary McDermott
Mary McDermott
Campbell L. Ayling

120 Bloomingdale Road
White Plains, NY 10605
914/644-5245

Their Attorneys

Dated: December 10, 1993